Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**22 JUNE 2018**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 31 March 2018)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	

List of attachments to this report:

Appendix 1 – Fund Valuation

Appendix 2 – Mercer Annual Investment Review

EXEMPT Appendix 3 – Changes in RAG status of Investment Managers

Appendix 4 – LAPFF Quarterly Engagement Monitoring Report

Appendix 5 – LGPS 2017/18 Fund Statistics

1 THE ISSUE

1.1 This paper reports on the investment performance of the Fund and seeks to update the Committee on routine strategic aspects of the Fund's investments and funding level. This report contains performance statistics for periods ending 31 March 2018.

1.2 The main body of the report comprises the following sections:

Section 4. Funding Level Update
Section 5. Investment Performance: A - Fund, B - Investment Managers
Section 6. Investment Strategy
Section 7. Portfolio Rebalancing and Cash Management
Section 8. Responsible Investment (RI) Update

2 RECOMMENDATION

The Avon Pension Fund Committee is asked to:

2.1 **Note the information set out in the report**

2.2 **Note LAPFF Quarterly Engagement Report at Appendix 4**

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund from 1 April 2016 will affect the next triennial valuation in 2019. Section 4 of this report discusses the trends in the Fund's liabilities and the funding level.

4 FUNDING LEVEL

4.1 Using information provided by the Actuary, Mercer has analysed the funding position as part of the report at Appendix 2 (section 2). This analysis shows the impact of both the assets and liabilities on the (estimated) funding level. **It should be noted that this is just a snapshot of the funding level at a particular point in time.**

4.2 Key points from the analysis are:

(1) The funding level has risen c.1% over the year from 95% to 96%.

(2) The improvement over the year was driven by a positive return on assets (particularly from emerging market equities, property and infrastructure) outweighing an increase in the present value of the liabilities.

5 ANNUAL INVESTMENT REVIEW

5.1 This quarter Mercer has provided an annual investment review of the year to 31 March 2018 (see Appendix 2) rather than the normal quarterly performance report.

5.2 The purpose of this report is to inform the Committee as to how the strategy has performed over the last year, whether the underlying assumptions of the investment strategy remain valid, and whether the investment manager structure is delivering against expectations.

6 INVESTMENT PERFORMANCE

A – Fund Performance

6.1 The Fund's assets increased by £252m (c.4.7%) over the year ending 31 March 2018 giving a value for the investment Fund of £4,608m. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and managers. Manager performance is monitored in detail by the Investment Panel. The Fund's investment return and performance relative to benchmark is summarised below.

Table 1: Fund Investment Returns

Periods to 31 March 2018

	3 months	12 months	3 years (p.a.)
Avon Pension Fund (incl. currency hedging)	-0.8%	4.7%	6.3%
Avon Pension Fund (excl. currency hedging)	-1.3%	3.0%	7.3%
Strategic benchmark (no currency hedging) *(Fund incl. hedging, relative to benchmark)*	-1.5% *(+0.7%)*	3.7% ***(+1.0%)***	7.3% *(-1.0%)*

6.2 **Fund Investment Return:** Over the year financial markets were largely driven by central bank policy where interest rates began to rise incrementally and central banks across developed regions scaled back their balance sheet expansion programs. Geopolitical factors were ever-present in market prices, although the UK's snap general election in June did nothing to hold back investor confidence as the US administrations pro-business policies pulled equity prices higher across the board. Strong positive performance from global equities was noted over the first 3 quarters of the year.

Yields in fixed interest bearing assets remained suppressed throughout the year in historical terms, reducing the cost of borrowing and in turn boosting equity prices. This affect was compounded by supportive economic and governmental policies across developed markets. The second half of the year built on the momentum of the record high equity prices touched in the first quarter, but did show signs of correcting toward the end of the year as the Federal Reserve started to incrementally increase rates, denting investor confidence. The sell-off deepened in the last month of the year on concerns over US trade sanctions on China and slower growth expectations from China and Europe.

The Fund's infrastructure assets contributed positively to investment returns. Hedge fund returns were negatively impacted by low cash rates and diversified growth funds failed to deliver in line with their absolute return targets. In general active managers failed to keep pace with passive index tracker mandates. The Fund's currency hedge was additive to returns as sterling rebounded from the sharp falls it had experienced in the prior year.

6.3 **Fund Performance versus Benchmark exclusive of LDI and cash impact: 0.6% over the year, attributed to**

(1) **Asset Allocation:** The contribution to outperformance from asset allocation was **0.1%** over the year. Positive contributions were made by an overweight to emerging market equities and an underweight to multi-asset credit.

(2) **Manager Performance:** In aggregate, the contribution of manager performance was **+0.5%** over the year. Overseas equities and infrastructure mandates had the biggest positive impact on total manager performance. In line with expectations given the market background, active manager impact was negative in emerging market and diversified growth funds. The fact active managers were not able to capture the market preference for 'value' stocks – where many hold portfolios tilted toward 'quality' stocks – led to minimal contribution to returns.

Note: Mercer has calculated attribution exclusive of LDI and cash over the year. The Fund's custodian, SSBT, could only provide total fund attribution analysis for 1Q18 (following the transfer to SSBT in December 2017). For this reason, total fund return over the year used for the purposes of attribution analysis does not match total fund return quoted in Table 1. Total fund attribution analysis for the financial year 2018/19 will be provided by SSBT.

6.4 **Currency Hedging:** The hedging programme is in place to manage the volatility arising from overseas currency exposure, in particular to protect the Fund as sterling strengthens and returns from foreign denominated assets reduce in sterling terms. The hedging programme contributed +0.5% to the total Fund return over the quarter and +1.7% over the year.

B – Investment Manager Performance

6.5 Under the Red Amber Green (RAG) framework for monitoring manager performance, the Panel consider updates on all managers not currently achieving Green status including progress on action points. Any change in the RAG status of any manager is reported to Committee with an explanation of the change. **This quarter one manager was assigned an Amber rating having reached 3 years since inception of the mandate** (see Exempt Appendix 3).

6.6 All but two investment mandates delivered positive absolute returns over the year to 31 March 2018. On a rolling 3 year basis, and with the exception of one DGF manager, all investment mandates delivered positive absolute returns. On a relative basis active equity managers failed to meet their respective performance targets and only two were able to outperform their benchmarks. At year end, 8 managers were rated 'Amber' according to the funds internal RAG performance monitoring framework.

6.7 The annual summary of LGPS Funds investment returns is in Appendix 5. This focuses purely on investment returns; it does not analyse investment risk or relate the returns for each fund to funding metrics. For example, some funds hedge certain risks; in Avon's case we hedge our foreign currency risk. If Avon's unhedged returns are used, the 1 year return falls as currency hedging enhanced sterling returns and the 3 year return improves as currency hedging detracted from sterling returns. Officers will use the information when reviewing the investment strategy in 2019/20 with particular focus on funds showing consistent returns over longer periods.

7 INVESTMENT STRATEGY

7.1 **Asset Class Returns:** Returns from developed equities, emerging market equities, fixed interest gilts and index- linked gilts outperformed the strategic assumptions over three years; the latter two were significantly ahead of the assumed return. Emerging market equities benefitted from increased risk appetite from investors and improving fundamental economic data, while continued accommodative monetary policy supported developed market equities. Hedge Funds lag their assumed return due to exceptionally low cash rates.

7.2 **Reduction in Equity Allocation:** The Fund's equity allocation decreased from 50% to 40% of total fund assets with a long term view of further reducing equity exposure to 37.5%. This decision was taken in the context of an improved funding level on the back of strong asset returns. With equity prices at elevated levels the Fund reduced its allocation to this asset class thereby reducing exposure to growth assets and introducing more stability to the contribution payments made by employers.

7.3 **Reduction in Corporate Bond Allocation:** The Fund's corporate bond allocation decreased from 8% to 2%. With yields on bonds at such low levels the return prospects for this asset class were deemed to be unsustainably low, with any increase in interest rates posing a threat to the capital return received on bonds.

7.4 **Investment in Multi-Asset Credit:** The reduction in equity and corporate bond exposures facilitated an investment into a new Multi Asset Credit mandate, designed to benefit from the premium attached to credit, which is a distinct asset class. Initially the allocation made to this mandate was 11% with a view to reducing it by 5% in the medium term and allocating to a long-lease property mandate.

7.5 **Increase in DGF allocation:** The Fund's allocation to DGFs increased by 5% to 15% - the rationale being to further reduce exposure to equities and benefit from a more diversified approach.

7.6 **Switch to Low Carbon:** The switch from passive regional funds to a Low Carbon fund served a dual purpose – to satisfy one of the Fund's strategic RI priorities (evaluation and management of carbon exposure) and to simultaneously address the overweight to UK equities by increasing the allocation to a global low carbon index.

7.7 **Equity Protection Strategy:** In addition to de-risking the Fund's equity portfolio by physically reducing the allocation to equities by 10% an equity protection strategy structured to compensate the Fund in the event of a sharp draw-down in equity markets was implemented. The intention is to give a greater level of certainty of asset values over the next triennial valuation.

7.8 **Liability Risk Management Framework:** The final phase of the Fund's liability risk management framework was implemented during 2017/18. The strategy is designed to more closely match the Fund's inflation linked cash flows and increase the certainty of asset returns in line with the assumed strategic return, ultimately increasing the certainty assets achieving the cash flows required to meet the pension payments as they fall due.

8 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

8.1 As at 31 March 2018 the Fund was within all strategic asset allocation ranges.

8.2 The Fund's large cash balance at year end can be attributed to increased capital being held at custody in anticipation of regulatory margining requirements and an increase in the value of the Fund's currency contracts; a proportion of which is settled in cash at the end of each month.

Cash Management

8.3 Cash is held by the managers at their discretion within their investment guidelines, and internally to meet working requirements. The officers closely monitor the management of the Fund's cash held by the managers and custodian with a particular emphasis on the security of the cash.

8.4 Management of the cash held internally by the Fund to meet working requirements is delegated to the Council's Treasury Management Team. The monies are invested separately from the Council's monies.

8.5 During the year there were no breaches of the Fund's Treasury Management Policy for 2017-18.

8.6 The 2017/18 Service Plan forecast an average cash outflow of c. £1.3m each month during the year to 31 March 2018, making a total outflow of £16.4m for the year to 31st March 2018. The outturn for the year was £17.1m. Further details are provided in the pension fund budget and cash flow monitoring report to this Committee.

9 CORPORATE GOVERNANCE UPDATE

9.1 During the quarter, the Fund's external managers undertook the following voting activity on behalf of the Fund:

Companies Meetings Voted:	471
Resolutions voted:	4939

Votes For:	4638
Votes Against:	235
Abstained:	64
Withheld* vote:	1

** A withheld vote is essentially the same as a vote to abstain, it reflects a view to vote neither for or against a resolution. Although the use of 'abstain' or 'withheld' reflects the different terms used in different jurisdictions, a 'withheld' vote can often be interpreted as a more explicit vote against management. Both votes may be counted as votes against management, where a minimum threshold of support is required.*

9.2 The Fund is a member of LAPFF, a collaborative body that exists to serve the investment interests of local authority pension funds. In particular, LAPFF seeks to maximise the influence the funds have as shareholders through co-ordinating shareholder activism amongst the pension funds. LAPFF's activity in the quarter is summarised in their quarterly engagement report at Appendix 4.

10 RISK MANAGEMENT

10.1 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund's future liabilities. This risk is managed via the Asset Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund and through the selection process followed before managers are appointed. This report monitors (i) the strategic policy and funding level in terms of whether the strategy is on course to fund the pension liabilities as required by the funding plan and (ii) the performance of the investment managers. An Investment Panel has been established to consider in greater detail investment performance and related matters and report back to the committee on a regular basis.

11 EQUALITIES

11.1 An Equality Impact Assessment has not been completed as this report is for information only.

12 CONSULTATION

12.1 This report is for information and therefore consultation is not necessary.

13 ISSUES TO CONSIDER IN REACHING THE DECISION

13.1 The issues to consider are contained in the report.

14 ADVICE SOUGHT

14.1 The Council's Monitoring Officer (Divisional Director – Legal and Democratic Services) and Section 151 Officer (Divisional Director – Business Support) have had the opportunity to input to this report and have cleared it for publication.

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Background papers	Data supplied by Mercer & SSBT Performance Services

Please contact the report author if you need to access this report in an alternative format